

FINANCIAL STATEMENTS

Magellan Health Services of Arizona, Inc. Year Ended June 30, 2008 With Report of Independent Auditors

Ernst & Young LLP



Financial Statements

Year Ended June 30, 2008

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Report of Independent Auditors

Magellan Health Services of Arizona, Inc.

We have audited the accompanying balance sheet of Magellan Health Services of Arizona, Inc. as of June 30, 2008, and the related statements of operations, changes in stockholder's equity and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. We were not engaged to perform an audit of the Company's internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Magellan Health Services of Arizona, Inc. at June 30, 2008, and the results of its operations and its cash flows for the year then ended, in conformity with U.S. generally accepted accounting principles.

Ernst + Young LLP

October 31, 2008

Certification Statement

June 30, 2008

ANNUAL CERTIFICATION STATEMENT OF MAGELLAN HEALTH SERVICES OF ARIZONA FOR THE YEAR ENDED JUNE 30, 2008

Name of Preparer:	Shannon Sieverling	
Title:	Chief Financial Officer	
Phone No:	602-797-8380	
the best of my know made a false stateme and/or state laws. In information requeste	ne information submitted in the reports hereing ledge. I understand that whoever knowing ent or representation with this report may be a addition, knowing and willfully failing to might result in denial of a request to paration of a T/RBHA's agreement or contract	and willfully makes or causes to be prosecuted under applicable federal o fully and accurately disclose the ticipate, or where the entity already
8		

Date Signed

Chief Financial Officer

Balance Sheet

June 30, 2008

Assets	
Cash and cash equivalents	\$ 63,158,629
Short-term investments	9,736,000
Accounts receivable	4,946,418
Current deferred income taxes	4,595,364
Prepaid expenses	1,334,726
Other assets	520,108
Total current assets	84,291,245
Property and equipment, net	6,886,796
Long-term investments	4,503,604
Non-current deferred income taxes	2,092,129
Other non-current assets	426,245
Total assets	\$ 98,200,019
Liabilities and stockholder's equity	
Liabilities:	
Medical claims payable	\$ 17,053,650
Payable to ADHS	8,391,227
Accounts payable and accrued expenses	2,602,259
Due to affiliates, net	12,917,540
Current portion of capital lease obligation	12,394
Other current liabilities	4,683,177
Total current liabilities	45,660,247
Long-term portion of capital lease obligation	39,422
Maricopa comcare trust	1,323,931
Total liabilities	47,023,600
Stockholder's equity:	
Common stock, \$0.10 par value; 1,000 shares authorized, issued, and	100
outstanding	100
Additional paid-in capital	56,000,000
Accumulated deficit	(4,817,462)
Accumulated other comprehensive loss	(6,219)
Total stockholder's equity	51,176,419
Total liabilities and stockholder's equity	\$ 98,200,019

See accompanying notes to the financial statements.

Statement of Operations

Year Ended June 30, 2008

Contract revenues Interest income Total revenues	\$ 508,791,526 1,917,824 510,709,350
Expenses: Cost of care	485,048,748
General and administrative expenses	37,316,100
Total expenses	522,364,848
Net loss before income taxes	(11,655,498)
Allocated corporate income tax benefit	(6,838,036)
Net loss	(4,817,462)
Other comprehensive loss	(6,219)
Comprehensive loss	\$ (4,823,681)

See accompanying notes to the financial statements.

Statement of Changes in Stockholder's Equity

	 nmon ock	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Loss	Total e Stockholder's Equity
Balance, June 30, 2007	\$ _	\$ -	\$ -	\$ -	\$ -
Initial Capitalization Additional capital	100	15,000,000	_	_	15,000,100
contribution	_	41,000,000	_	_	41,000,000
Net loss Other comprehensive	_	_	(4,817,462)	_	(4,817,462)
loss	_	_	_	(6,219)	(6,219)
Balance, June 30, 2008	\$ 100	\$ 56,000,000	\$ (4,817,462)	\$ (6,219)	\$ 51,176,419

See accompanying notes to the financial statements.

Statement of Cash Flows

Year Ended June 30, 2008

Cash flows from operating activities	
Net loss	\$ (4,817,462)
Adjustments to reconcile net loss to net cash provided by operating activities:	
Depreciation	5,807,208
Deferred income tax benefit	(6,687,493)
Changes in assets and liabilities:	
Accounts receivable	(4,946,418)
Prepaid expenses	(1,334,726)
Other assets	(946,353)
Medical claims payable	17,053,650
Payable to ADHS	8,391,227
Accounts payable and accrued expenses	2,602,259
Due to affiliates, net	12,917,540
Other liabilities	6,010,456
Net cash provided by operating activities	34,049,888
Cash flows from investing activities	
Capital expenditures	(12,635,414)
Purchases of investments	(14,249,171)
Net cash used in investing activities	(26,884,585)
Cash flows from financing activities	
Contributions from parent	56,000,000
Issuance of common stock	100
Payments of capital lease obligation	(6,774)
Net cash provided by financing activities	55,993,326
Not shange in each and short town investments	62 150 620
Net change in cash and short-term investments	63,158,629
Cash and short-term investments, beginning of year	
Cash and short-term investments, end of year	\$ 63,158,629

See accompanying notes to financial statements.

Notes to Financial Statements

June 30, 2008

1. Organization

Magellan Health Services of Arizona, Inc. (the Company) is a wholly owned subsidiary of Magellan Behavioral Health, Inc. (the Parent), which is a wholly owned subsidiary of Magellan Health Services, Inc. (Magellan). Magellan is engaged in the specialty managed healthcare business, and provides managed behavioral healthcare services, radiology benefits management and specialty pharmaceutical management.

The Company was incorporated and organized in 2004 as a behavioral health organization. In 2007, the Company was awarded a contract with the Arizona Department of Health Services (ADHS) which commenced September 1, 2007 and expires June 30, 2010 (the Contract). In accordance with the Contract, the Company has been designated as the Regional Behavioral Health Authority (RBHA) for the geographic service area of Maricopa County. The Company is responsible for managing and maintaining an organized, comprehensive behavioral healthcare delivery system for the benefit of eligible members within its geographic service area. All of the Company's revenues and accounts receivable are from the Contract.

Effective with the commencement of the Contract, the Company was required to purchase twenty-four behavioral health direct care facilities (the Clinics) from the vendor that previously serviced Maricopa County. The Company will operate the Clinics for a transitional period until such time that the Company can divest itself of these facilities as required by the Contract. The total purchase price for the clinics was \$10.8 million, with such purchase price allocated as follows (amounts in millions):

Fixed assets	\$ 7.0
Other assets	1.6
Contract start-up costs	2.2
Total	\$ 10.8

The Contract start-up costs were immediately expensed.

2. Summary of Significant Accounting Policies

Basis of Presentation

These financial statements have been prepared on the accrual basis of accounting in accordance with accounting principles generally accepted in the United States.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, disclosure of contingent assets and liabilities at the date of the financial statements, and the reported amounts of revenue and expenses during the reporting period. Significant estimates of the Company include, among other things, accounts receivable realization, medical claims payable and legal liabilities. Actual results could differ from those estimates.

Fair Value of Financial Instruments

Statement of Financial Accounting Standards (SFAS) No. 107, *Disclosure about Fair Value of Financial Instruments*, requires disclosure of fair value information about financial instruments for which it is practicable to estimate the value. The carrying value for the Company's financial instruments classified as current assets (other than short-term investments) and current liabilities approximate their fair value due to their short maturities. The Company's short-term and long-term investments have been classified as "available-for-sale" and are carried at fair value, based on quoted market prices.

Cash and Cash Equivalents

The Company considers all liquid investments with an original maturity of three months or less when purchased to be cash equivalents.

Investments

Investments consist primarily of obligations of government-sponsored enterprises and corporate debt securities. The Company's policy is to classify all investments with contractual maturities within one year as current. Investment income is recognized when earned and reported net of investment expenses. Net unrealized holding gains or losses are excluded from earnings and are reported, net of tax, as "accumulated other comprehensive loss" in the accompanying balance sheet, statement of operations and statement of changes in stockholder's equity until realized, unless the losses are deemed to be other-than-temporary. Realized gains or losses, including any provision for other-than-temporary declines in value, are included in the statement of operations.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

The Company periodically evaluates whether any declines in the fair value of investments are other-than-temporary. This evaluation consists of a review of several factors, including but not limited to: the length of time and extent that a security has been in an unrealized loss position; the existence of an event that would impair the issuer's future earnings potential; the near-term prospects for recovery of the market value of a security; and the intent and ability of the Company to hold the security until the market value recovers. Declines in value below cost for investments where it is considered probable that all contractual terms of the investment will be satisfied, is due primarily to changes in interest rates (and not because of increased credit risk), and where the Company intends and has the ability to hold the investments for a period of time sufficient to allow a market recovery, are not assumed to be other-than-temporary. The Company periodically reviews those investment securities whose unrealized losses have remained unrealized for more than six months to determine if such unrealized losses are other-than-temporary. Unrealized losses related to investments greater and less than one year are not material.

In relation to its investment securities, the Company is not aware of the existence of any financial difficulties for any of the issuers of such investment securities which would cause the Company to question whether such issuers will be able to honor such investment securities upon maturity. Further, the Company believes the declines in fair value of its investment securities were caused by changes in market interest rates. The Company intends to hold these related investment securities to maturity and has the ability to do so. As of June 30, 2008, there were no unrealized losses that the Company believed to be other-than-temporary. No realized gains or losses were recorded for the year ended June 30, 2008.

The following is a summary of short-term and long-term investments as of June 30, 2008:

		Gross	
	Amortized Cost	Unrealized Gains/(Losses)	Estimated Fair Value
Obligations of government-sponsored	.		
enterprises ⁽¹⁾ Corporate debt securities	\$ 9,733,000 4,516,171	\$ 3,000 (12,567)	\$ 9,736,000 4,503,604
Total investments at June 30, 2008	\$ 14,249,171	\$ (9,567)	\$ 14,239,604

⁽¹⁾ Includes investments in notes issued by the Federal Home Loan Mortgage Corporation.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

The maturity dates of the Company's investments as of June 30, 2008 are summarized below:

	Amortized Cost	Estimated Fair Value
Due in one year or less Due after one year through June 30, 2010	\$ 9,733,000 4,516,171	\$ 9,736,000 4,503,604
Total investments at June 30, 2008	\$ 14,249,171	\$ 14,239,604

Revenue Recognition

The Company receives a portion of its Contract funding in the form of capitation revenue, which is recognized over the applicable coverage period on a per member basis for covered members. Under this arrangement, the Company is paid a per member fee for all enrolled members, and this fee is recorded as revenue in the month in which members are entitled to service. The Company adjusts its revenue for retroactive membership terminations, additions and other changes, when such adjustments are identified, with the exception of retroactivity that can be reasonably estimated. Any fees paid prior to the month of service are recorded as deferred revenue. Capitation revenues were approximately \$405.8 million for the year ended June 30, 2008. The Contract is partially funded by federal, state and county block grant money, which represents annual appropriations. The Company recognizes revenue from block grant activity ratably over the period to which the block grant funding applies. Block grant revenues were approximately \$102.8 million for the year ended June 30, 2008.

Contract revenue is also limited by the terms of the Contract to a maximum profit percentage, as defined. Contract revenue that cannot be recognized due to the profit limits (four percent) or approximately \$0.6 million at June 30, 2008 is included in "payable to ADHS" in the accompanying balance sheet.

Cost of Care and Medical Claims Payable

Cost of care includes costs incurred by the Company to operate the Clinics, as well as costs incurred related to care that has been provided by third parties. Expenses for the Clinics include salaries, rent, utilities and other operating costs, all of which are recognized as incurred.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Cost of Care and Medical Claims Payable (continued)

Cost of care provided by third parties is recognized in the period in which members receive managed healthcare services. In addition to actual benefits paid, cost of care includes the impact of accruals for estimates of medical claims payable. Medical claims payable represents the liability for healthcare claims reported but not yet paid and claims incurred but not yet reported (IBNR) related to the Company's managed healthcare business. Such liabilities are determined by employing actuarial methods that are commonly used by health insurance actuaries and meet actuarial standards of practice.

The IBNR portion of medical claims payable is estimated based on past claims payment experience for member groups, enrollment data, utilization statistics, authorized healthcare services and other factors. This data is incorporated into contract-specific actuarial reserve models and is further analyzed to create "completion factors" that represent the average percentage of total incurred claims that have been paid through a given date after being incurred. Factors that affect estimated completion factors include benefit changes, enrollment changes, shifts in product mix, seasonality influences, provider reimbursement changes, changes in claims inventory levels, the speed of claims processing, and changes in paid claim levels. Completion factors are applied to claims paid through the financial statement date to estimate the ultimate claim expense incurred for the current period. Actuarial estimates of claim liabilities are then determined by subtracting the actual paid claims from the estimate of the ultimate incurred claims. For the most recent incurred months (generally the most recent two months), the percentage of claims paid for claims incurred in those months is generally low. This makes the completion factor methodology less reliable for such months. Therefore, incurred claims for any month with a completion factor that is less than 70 percent are generally not projected from historical completion and payment patterns; rather they are projected by estimating claims expense based on recent monthly estimated cost incurred per member per month times membership, taking into account seasonality influences, benefit changes and health care trend levels, collectively considered to be "trend factors."

Expense Allocation

Certain direct, indirect and administrative expenses are incurred which benefit more than one program. Such common expenses are allocated based upon an ADHS approved cost allocation plan as submitted by the Company.

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Long-lived Assets

Long-lived assets, including property and equipment, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount should be addressed pursuant to SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets* (SFAS 144). Pursuant to this guidance, impairment is determined by comparing the carrying value of these long-lived assets to management's best estimate of the future undiscounted cash flows expected to result from the use of the assets and their eventual disposition. The cash flow projections used to make this assessment are consistent with the cash flow projections that management uses internally in making key decisions. In the event an impairment exists, a loss is recognized based on the amount by which the carrying value exceeds the fair value of the asset, which is generally determined by using quoted market prices or the discounted present value of expected future cash flows. No impairment of long-lived assets was identified during the year ended June 30, 2008.

Property and Equipment

Property and equipment is stated at cost, except for assets that have been impaired, for which the carrying amount has been reduced to estimated fair value. Expenditures for renewals and improvements are capitalized to the property accounts. Replacements and maintenance and repairs that do not improve or extend the life of the respective assets are expensed as incurred. Amortization of capital lease assets is included in depreciation expense and is included in accumulated depreciation as reflected in the table below. Depreciation expense was \$5.8 million for the year ended June 30, 2008.

The Company provides for depreciation using the straight-line method over the following general range of estimated useful lives:

Computer hardware and software	3-5 years
Furniture	15 years
Equipment	5 years
Leasehold improvements	5 years
Capital leases – equipment	4 years
Clinic assets	18 months

Notes to Financial Statements (continued)

2. Summary of Significant Accounting Policies (continued)

Property and Equipment (continued)

Property and equipment consists of the following as of June 30, 2008:

Furniture and equipment	\$ 4,078,184
Leasehold improvements	338,109
Capital leases – equipment	58,256
Clinic assets	8,219,455
	12,694,004
Accumulated depreciation	(5,807,208)
Property and equipment, net	\$ 6,886,796

Recent Accounting Pronouncement

In September 2006, the FASB issued FASB Statement No. 157, Fair Value Measurements (Statement 157), which establishes a framework for measuring fair value in accounting principles generally accepted in the United States, and expands disclosures about fair value measurements. Statement 157 applies to other accounting pronouncements that require or permit fair value measurements and, accordingly, Statement 157 does not require any new fair value measurements. Statement 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 for financial assets and liabilities, and interim periods within those fiscal years. The Company is currently evaluating the potential impact the adoption of this statement will have on its financial position and results of operation.

3. Contract Requirements

In accordance with the Contract, the Company is required to maintain certain minimum financial reporting and viability measures.

The Company must maintain unrestricted, minimum capitalization of at least ninety percent of the monthly capitation and block payments received under the Contract. At June 30, 2008, the Company was in compliance with this requirement.

The Contract contains various quarterly financial performance requirements, including required minimum liquidity ratio, administrative cost percentage and service expense percentages. The Company was not in compliance with certain administrative expense percentages and certain

Notes to Financial Statements (continued)

3. Contract Requirements (continued)

service expense percentages for the year ended June 30, 2008. The Company has informed ADHS of the reasons for these variances and ADHS has not informed the Company of any required corrective action.

Should the Company be in default of any material obligations under the Contract, ADHS may, at its discretion, in addition to other remedies, either adjust the amount of future payments or withhold future payment until satisfactory resolution of the default or exception. In addition, although it has not expressed an intention to do so, ADHS has the right to terminate the Contract in whole or in part without cause by giving the Company 90 days written notice. Further, if monies are not appropriated by the state or are not otherwise available, the Contract may be cancelled upon written notice until such monies are so appropriated or available.

As of June 30, 2008, the Company reported less than the minimum number of encounters as stipulated in the Contract and is subject to a potential encounter withhold by ADHS if no more encounters are submitted. The Company has until February 28, 2009 to submit encounters related to the year ended June 30, 2008. Due to the uncertainty as to whether the Company will meet the required encounter threshold, a liability in the amount of \$7.5 million has been recorded as of June 30, 2008. In addition, the Company is subject to a profit risk corridor calculation that calculates a return of premium to the extent certain financial percentages are not met by program types. The Company recorded a return of premium of approximately \$0.6 million as a result of the profit risk corridor calculation for the year ended June 30, 2008. These amounts are included in "payable to ADHS" in the accompanying balance sheet.

ADHS has the right to sanction the Company for other matters of non-compliance of the Contract, as determined by ADHS. As of June 30, 2008, the Company has accrued a liability in the amount of \$0.2 million for potential sanctions. Such amount is included in "payable to ADHS" in the accompanying balance sheet.

The Company is limited by the terms of the Contract to profit that can be earned under the various programs. Contract profit limitations are applied on an after-tax basis.

4. Allocated Corporate Income Tax Benefit

For federal income tax reporting purposes, the Company's operations are included in Magellan's consolidated federal income tax returns. Magellan has a federal income tax year end of December 31. The Company files a separate state income tax return. Both Magellan and the Company file their federal and state returns on a calendar year basis.

Notes to Financial Statements (continued)

4. Allocated Corporate Income Tax Benefit (continued)

The Company has a tax sharing allocation agreement with Magellan. Under the terms of this agreement, Magellan has allocated a \$6.8 million federal tax benefit to the Company for the year ended June 30, 2008. The agreement calls for an allocation based on Magellan's federal statutory rate and the applicable state rate before reflecting the allocation and after affecting for permanent differences. For the statutory year ended June 30, 2008, the Company's permanent differences mainly consisted of \$7.9 million of overhead allocations for tax purposes which exceeded those recorded for book purposes due to limitations under the Contract. In accordance with the tax allocation agreement, allocated corporate federal income taxes payable or recoverable are required to be settled within 30 days after the filing by Magellan of any annual federal income tax return that includes the activities of the Company.

The benefit for income taxes for the year ended June 30, 2008 consisted of the following:

Income taxes currently receivable: Federal State	\$ 150,543 -
	150,543
Deferred income taxes:	
Federal	6,687,493
State	
	6,687,493
	\$ 6,838,036

As of June 30, 2008, the Company's valuation allowance was \$0.9 million, which primarily relates to certain state net operating losses and other state deferred tax assets.

Notes to Financial Statements (continued)

4. Allocated Corporate Income Tax Benefit (continued)

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and liabilities at June 30, 2008 are as follows:

Current deferred tax assets:	
Encounter threshold reserves	\$ 2,969,991
Other contract liabilities	2,220,039
Total current deferred tax assets	5,190,030
Valuation allowance	(594,666)
Current deferred tax assets after valuation allowance	\$ 4,595,364
Non-current deferred tax assets:	
Property and depreciation	\$ 932,005
Other	1,450,338
Total non-current deferred tax assets	2,382,343
Valuation allowance	(290,214)
Non-current deferred tax assets after valuation allowance	\$ 2,092,129

5. Related Party Balances and Transactions

Magellan and affiliated companies provide administrative and other services to the Company, including systems functions, accounts payable and payroll processing. Included in general and administrative expenses is an allocation of the costs of the administrative services provided by affiliated companies. The Company's allocation was \$24.9 million for the year ended June 30, 2008.

Amounts due to affiliated companies are due on demand and are non-interest bearing.

Under the provisions of the Contract, equity distributions may be paid to the Parent only to the extent of allowable profit in each of the funding sources as defined. For the year ended June 30, 2008, no distributions were declared or paid to the Parent.

6. Claims Unpaid

Claims unpaid balances are continually monitored and reviewed. If it is determined that the Company's assumptions in estimating such liabilities are significantly different than actual results, the Company's results of operations and financial position could be impacted in future periods. Adjustments of prior period estimates may result in additional claims costs or a

Notes to Financial Statements (continued)

6. Claims Unpaid (continued)

reduction of claims costs in the period an adjustment is made. Further, due to the considerable variability of health care costs, adjustments to claims unpaid occur each period and are sometimes significant as compared to net income recorded in that period. Prior period development is recognized immediately upon the actuary's judgment that a portion of the prior period liability is no longer needed or that additional liability should have been accrued.

The following table presents the components of the change in claims unpaid for the year ended June 30, 2008:

Medical claims payable, beginning of period	
Cost of care:	
Current year	485,048,748
Prior years	
Total cost of care	485,048,748
Payments related to cost of care	
Current year	(461,045,196)
Prior years	
Total payments related to cost of care	(461,045,196)
Reclass ⁽¹⁾	(6,949,902)
Medical claims payable, end of period	\$ 17,053,650

⁽¹⁾ Amount relates to the cost of care portion of the encounter threshold which is reflected in "payable to ADHS" in the accompanying balance sheet. See further discussion of the encounter threshold in Note 3 to the audited financial statements.

Actuarial standards of practice require that claims unpaid be adequate under moderately adverse circumstances. Adverse circumstances are situations in which the actual claims experience could be higher than the otherwise estimated value of such claims. In many situations, the claims paid amount experienced will be less than the estimate that satisfies the actuarial standards of practice.

Due to the existence of risk sharing provisions in the contract, a change in the estimate of claims unpaid does not necessarily result in an equivalent impact on claims costs.

Notes to Financial Statements (continued)

6. Claims Unpaid (continued)

The Company believes that the amount of claims unpaid is adequate to cover its ultimate liability for unpaid claims as of June 30, 2008; however, actual claims payments may differ from established estimates.

7. Commitments and Contingencies

Capital Lease Obligation

The Company has a capital lease related to the purchase of equipment. The capital lease has an interest rate of 6.87% and has scheduled maturities of \$12,394, \$14,439, \$15,462 and \$9,521 for the years ended June 30, 2009, 2010, 2011 and 2012, respectively.

Operating Leases

Operating leases have been executed for various operating facilities and equipment which are used to support the Company's business. Certain of these leases have been executed by the Parent on behalf of the Company, and other leases have been executed by the Company itself. The leases generally require the payment of all maintenance, property taxes and insurance costs. For leases which have been executed by the Parent, actual lease costs incurred are charged directly to the Company. Total rent expense, inclusive of costs related to leases executed by the Parent, was \$6.9 million for the year ended June 30, 2008. Leases executed by the Company expire at various dates through August 31, 2015.

At June 30, 2008, aggregate amounts of future minimum payments under operating leases which have been executed by the Company were as follows:

Year ending June 30:	
2009	\$ 6,330,196
2010	4,577,898
2011	1,311,152
2012	403,174
2013	382,482
Thereafter	867,690
	\$ 13,872,592

Notes to Financial Statements (continued)

7. Commitments and Contingencies (continued)

Regulatory Issues

The specialty managed healthcare industry is subject to numerous laws and regulations. The subjects of such laws and regulations cover, but are not limited to, matters such as licensure, accreditation, government healthcare program participation requirements, information privacy and security, reimbursement for patient services, and Medicare and Medicaid fraud and abuse. Over the past several years, government activity has increased with respect to investigations and/or allegations concerning possible violations of fraud and abuse and false claims statutes and/or regulations by healthcare organizations and insurers. Entities that are found to have violated these laws and regulations may be excluded from participating in government healthcare programs, subjected to fines or penalties or required to repay amounts received from the government for previously billed patient services. Compliance with such laws and regulations can be subject to future government review and interpretation, as well as regulatory actions unknown or unasserted at this time.

Legal

From time to time, the Company is involved in legal actions arising in the ordinary course of business. After taking into consideration legal counsel's evaluation of such actions, management believes that the resolution of such legal actions will not have a material adverse effect on the Company's financial condition or results of operations; however, there can be no assurance in this regard.

Insurance

The Company is covered under Magellan's general, professional and managed care liability insurance policies with unaffiliated insurers for a one year period, with the current policy extending from June 17, 2008 through June 17, 2009. The general liability policies are written on an "occurrence" basis, with the professional liability and managed care errors and omissions liability policies written on a "claims-made" basis.

In relation to the Company's planned divestiture of the Clinics, the Company intends to purchase professional and general liability tail insurance coverage. The Company is ratably accruing for the estimated cost of the tail insurance coverage over the first twelve months that the Company operates the clinics. As of June 30, 2008, the Company has accrued approximately \$ 3.7 million for tail insurance coverage with such amount included in "other current liabilities" in the accompanying balance sheet.

Notes to Financial Statements (continued)

8. Subsequent Events

In August 2008, the Company entered into an agreement to sell five of the Company's Clinics over the remainder of calendar year 2008. In September 2008, the Company entered into an additional agreement to sell eight of the Company's Clinics over the remainder of calendar year 2008 and the first quarter of 2009. The divestiture of the clinics is required under the Contract.

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